

# ***THE RICHBÄCHER LETTER***

*Monthly Analysis of Currencies and Credit Markets*

NUMBER 351

AUGUST 2002

---

**“A currency authority has no direct concern with the level of value of existing securities, as determined by opinion, but... it has an important indirect concern if the level of value of existing securities is calculated to stimulate new investment to outrun saving, or contrariwise... The main criterion for interference with a ‘bull’ or a ‘bear’ financial market should be... the reactions of this financial situation on the prospective equilibrium between savings and new investment.”**

**John Maynard Keynes, *A Treatise on Money*, 1930**

## **THE LOOMING DOLLAR DISASTER**

What happens to the U.S. economy is the key issue for the global economy and global stock markets. Led by Wall Street, their slide, lasting now well over two years, has sharply accelerated. Worsening market psychology is the conventional and also comforting explanation, suggesting a disconnect between the economy and stock market. Not for the first time, we vehemently dissent. Incidentally, it is an explanation that passes over the truly decisive, objective causes underlying this dismal development of the markets.

In fact, irrespective of the stock market’s slide, official mantra and public opinion in America remain in flat denial of the tremendous dislocations that the egregious credit excesses of the past several years have inflicted on the U.S. economy and its financial system.

This letter is largely devoted to what we regard as the single worst threat not only to the U.S. economy and its financial markets but also to the world economy, implying to foreign investors huge currency losses on top of their huge losses in stocks and bad loans.

Careful analysis of the potential destructive forces suggests that when the dollar’s plunge develops in earnest, it will — in contrast to its steep decline in the 1980s — be brutal for the U.S. financial markets, which have become hostage to massive foreign capital inflows.

### **FOREIGN FAITH**

Regardless of drastically weakening U.S. economic activity, a plunging stock market and the Fed slashing its interest rate below the officially-targeted euro-area interest rate, the dollar continued to appreciate during 2001 against the currencies of other major industrial countries, on average by 6%.

This behavior of the currency flagrantly contrasted with normal, past experience. The reasonable explanation is that foreign faith in the U.S. economy’s superior performance and prospects had until then remained untouched by the dismal facts. Reflecting record-high capital inflows, foreign-owned assets in the United States soared by \$895.5 billion in 2001, though lagging the previous year’s record inflow of \$1,024.2 billion.

Some \$285 billion of these capital inflows still went into U.S. stocks in 2001, down from \$481 billion in 2000. Foreigners were definitely the single strongest support for America’s stock market during these two critical years. Without this money from abroad, U.S. stocks would clearly have encountered a far steeper slide. The bulk of the massive foreign buying both of U.S. equities and corporate bonds, by the way, came from Europe.

### **THE GREATEST RISK FOR THE WORLD ECONOMY**

In the second quarter of 2002, dollar strength quite abruptly gave way to pronounced dollar weakness. While it took the U.S. currency more than two years to rise 20% against the euro and yen, it has now lost this

gain within a few months. All the more, it strikes us that serious anxiety about a possible uncontrollable dollar crash is completely lacking.

The apparent general expectation is for a limited downward correction to a *reasonable level*, fostering a lower current-account deficit and letting some air out of the inflated U.S. capital account. It's another dangerous illusion. Most likely, in our view, the dollar bubble will burst within a rather short period, hitting the U.S. financial markets with a vengeance.

For a long time, we have been warning that the dollar's strength is pure bubble strength. Gross illusions about the U.S. economy's health and strength have for a few years engendered capital inflows of fantastic but unsustainable scale. Like all bubbles, it is bound to burst. The collapsing dollar will spell doom for the U.S. financial markets, both bonds and stocks. In fact, *such a collapse is the single greatest risk for the world economy.*

It is a measure of the macroeconomic costs of an unbelievably reckless monetary policy that has allowed economic and financial imbalances to grow to disastrous extremes. In this respect, we see frightful differences between the present financial situation in the United States and that of the 1980s, when the dollar plunged in splendid isolation from the financial markets.

### **THE TRUE ATROCIOUS FINANCING GAP**

Assessment of the dollar's prospects generally centers on the huge deficit in the current account (running lately at \$450 billion annually and rising) and the corresponding need for capital inflow. As a matter of accounting, the two are always equal. Still, this approach is grossly misleading because the so-called net capital inflow represents only *one* part of the U.S. external financing requirements. In fact, it represents the *smaller* part.

The larger part takes the form of American portfolio and corporate direct investments abroad. These U.S. foreign investments amounted to \$439.6 billion in 2001, after \$581 billion in 2000. Given the lack of surplus on current account, these U.S. capital exports, too, essentially require funding through capital imports. Coming on top of the current-account deficit of \$445 billion and \$417 billion, there results a need for capital inflows into the United States between \$900–\$1,000 billion per year just to keep the dollar stable and the U.S. financial system afloat.

*To expect continuous new capital inflows of such size, funding both current and capital outflows, appears ludicrous to us.*

The point is that for the dollar to slide, foreign investors do not have to become net sellers of U.S. assets. It is merely enough that new foreign investment and lending fall short of those two current financial outflows. To imagine that capital inflows can continue on the huge scale of the recent past beggars reasonable thinking.

Though conjuring up a horrible scenario, it's only part of the dollar's horror story. Foreign investors are already exposed to the exchange risk through their vast, *existing*, holdings of U.S. financial assets. They now own more than \$9 trillion of U.S. financial assets at market value and around \$8 trillion at current cost.

This total includes about \$4.4 trillion of equities at market value and about \$2.5 trillion of government and corporate bonds. Not included in these two numbers are the dollar assets held by foreign central banks, overwhelmingly invested in government bonds and now approaching \$1 trillion.

At issue is the possible or probable response of foreign owners of these financial assets to a falling dollar. In the U.S. case, it's the foreign investor who typically carries this risk. It is a compelling conclusion that the bulk of these foreign holdings of dollar assets are not covered against the risk of a falling dollar.

Given higher short-term interest rates in Europe, hedging the exchange risk through dollar sales in the forward market would have even brought a small gain. But entranced by the new paradigm propaganda about the U.S. economy and counting, therefore, on endless dollar strength, foreign investors and lenders beheld nothing but the risk of missing much fatter currency gains from a rising dollar, and that required uncovered dollar holdings.

## **THE MONSTROUS DOLLAR OVERHANG**

Our nightmare is that continuous bad news about the U.S. economy and an associated continuous fall of the dollar will sooner or later induce a significant part of foreign investors and lenders to pull out of the dollar, once they awaken to the immensity of the inherent risks. But even if they decide to stay put with their U.S. investments, the development of large-scale one-sided hedging against further dollar depreciation will essentially produce exactly the same downward pressure on the dollar.

This exposure to the exchange-rate risk on the vast mass of existing foreign-owned assets is one of the most critical differences between the situation during the dollar crisis of the 1980s and the situation the United States faces at present.

The numbers tell the story.

At year-end 1985, the figures show the United States still as a net creditor nation to the tune of \$142 billion.

<b>U.S. INTERNATIONAL INVESTMENT POSITION (BILLIONS OF DOLLARS)</b>			
	<b>U.S. Assets Abroad</b>	<b>Foreign Assets in the U.S.</b>	<b>Net</b>
<b>1985</b>	1,244	1,102	+ 142
<b>2000</b>	6,862	9,172	- 2,310
<i>Source: Survey of Current Business</i>			

It turned into a net debtor nation in 1987. Between 1985 and 1990, the United States recorded a cumulative current-account deficit of \$629 billion and an overall capital outflow at current cost of \$708 billion. By 1990, it had run up a net external indebtedness of \$294 billion (foreign-owned U.S. assets minus U.S.-owned assets abroad).

According to the latest available figures, U.S. net foreign indebtedness, reflecting the cumulative current-account deficit, amounted to \$2.3 trillion at market value at end-2000, and to \$1.9 trillion at current cost. Considering that the current-account deficit keeps running at an annual rate of more than \$400 billion, net external indebtedness is now rapidly approaching \$3 trillion, or about 30% of GDP. And please note: 90% of that net debt increase has been incurred during the 1990s.

To emphasize the key point again: The total exposure by foreigners to the U.S. dollar — as measured by aggregate foreign-owned assets in the United States — amounts to well over \$9 trillion. And yet this is still not the end of the horror story.

## **THE GREAT FOREIGN STOCK AND BOND BINGE**

Correlated with this enormous dollar exposure of foreign investors and lenders is an unprecedented scale of foreign involvement both in the U.S. bond and stock market. In this respect, too, the reported numbers are just stunning.

Judging by these numbers, foreign investors and lenders have played a key role in sustaining the U.S. financial system's viability in recent years. Implicitly, they were the most important single group of investors fueling Wall Street's bull run. During the three years 1999-2001, they pumped altogether \$1.8 trillion into the U.S. securities markets, roughly half-and-half into stocks and bonds. While their stock purchases sharply slowed in the course of last year from their extremely high levels in the boom years, they sharply stepped up their bond purchases. Dollar über alles.

The essential implication of this heavy foreign involvement in the U.S. securities markets is that a plunging dollar is by no means only a currency problem. With foreign stakes both in the U.S. stock and the bond market now so high, the whole U.S. financial system is clearly entangled by a falling dollar.

This is another decisive and ominous difference to the dollar crisis of the 1980s. Then, foreign investors were still marginal in the U.S. securities markets.

Hoping to find clues for the present, we took a closer look at the dollar's crash in the 1980s. There are, of

course, great similarities. The striking coincidences are in the strong cyclical divergence between a booming U.S. economy and sluggish economic growth in the rest of the world, a soaring U.S. export-import gap, rampant money growth, a bullish stock market and a sharply rising U.S. dollar.

Yet there are also whopping contrasts that make any comparisons between the present situation and that in

the 1980s highly dubious. Generally speaking, literally everything went to far greater excess in the later 1990s.

Both the economy's and the dollar's boom crested jointly in the first half of 1985, when U.S. economic activity showed the first signs of faltering. The dollar's following slide undid the prior big gains within just two years.

#### U.S. CAPITAL INFLOWS (BILLIONS OF DOLLARS)

	1999	2000	2001
<b>Net Foreign Purchases of U.S. Securities</b>	323.5	432.9	514.2
<b>Stocks</b>	113.0	192.7	127.2
<b>Bonds (Other Than Treasury)</b>	231.0	292.9	371.2
<b>Direct Investment, net*</b>	301.0	287.7	157.9
<b>Non-bank Liabilities**</b>	69.1	177.0	98.2

\*Mergers and Acquisitions, \*\*Lending of Foreign banks to U.S. corporations.

Source: Survey of Current Business

During its bull run, the dollar had skyrocketed against the deutsche mark from DM 1.72 in 1980 to DM 3.47 by late February 1985. By mid-April, it had lost 15% against the European currencies and 7% against the yen. Yet there were repeated rallies.

### PLANNING THE DOLLAR'S FALL

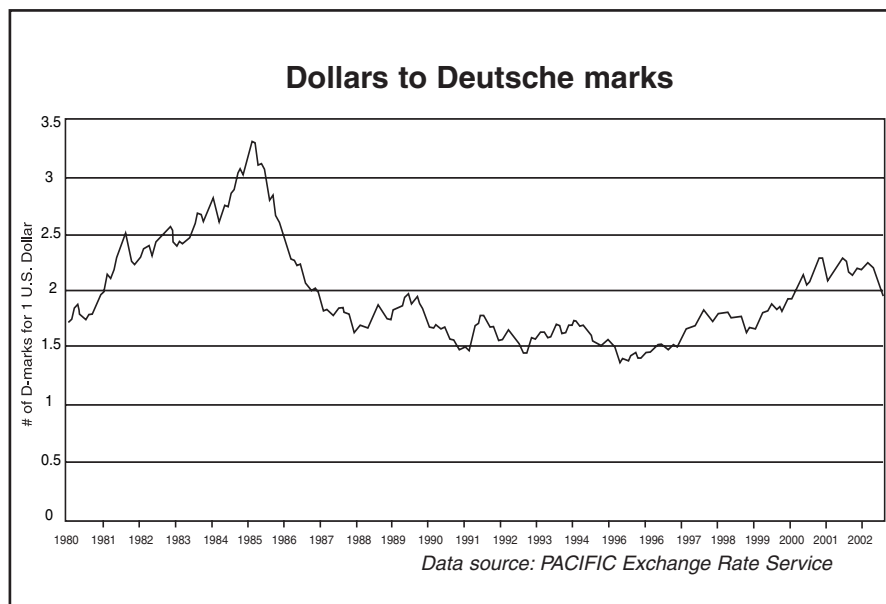
Determined to prevent any lasting recovery and desiring a still faster fall, the G5 finance ministers agreed in the Plaza Agreement of Sept. 22, 1985 to precipitate the dollar's decline by substantial joint interventions. The secret provisions featured up to six weeks of interventions to initially knock 10–12% off the dollar.

In the event, the mere “announcement effect” proved far more powerful than expected. Monday morning the dollar was already plunging well before the central banks' interventions had started. After the six weeks foreseen for intervention, the dollar's depreciation — by 13% against the yen and 10.5% against the DM — somewhat exceeded the Plaza targets. But remarkably, it had required far smaller interventions than had originally been planned, ultimately totaling only \$8.2 billion. Most importantly of all, however, the dollar's reversal was achieved without great disturbances in the financial markets — at least initially. Eventually, they would hit with a vengeance, in late 1987.

Over time it apparently began to unnerve the financial markets that the sharply falling dollar completely failed to improve the U.S. trade deficit, which continued to edge up. Just days after Alan Greenspan took over at the helm of the Fed, bonds, stocks and the dollar went into a tailspin.

The final countdown to the spectacular crash in 1987 can be traced to 8:30 a.m. on Oct. 14. A month before it had been reported that the trade deficit had improved

on a month-over-month basis, but by less than expected. Then, on Oct. 14, the Commerce Department



announced a whopping August U.S. trade deficit of \$15.7 billion.

From that moment on, it was a triple slide for U.S. stocks, bonds and the dollar, as the stage was set for Black Monday, Oct. 19, 1987. On that day, all sorts of negative records were set in the financial markets. Within a single day, the U.S. stock market had lost 22.6% in value, overshadowing the drop of 12.9% on Black Tuesday in October 1929.

There is a widespread view that Mr. Greenspan saved the day at the time with prompt and drastic monetary easing. In hindsight, it appears that better-than-expected economic numbers in the following months played the key role in stabilizing the dollar and the markets. In particular, the dreaded trade deficit rapidly improved. Economic facts, after all, do count.

### **A CRUCIAL, NEGATIVE DIFFERENCE**

Trying to assess the present global economic and financial prospects, we primarily ponder two questions: one is the vulnerability of the dollar; the other is the economy's widely trumpeted recovery. Our view on both subjects is certainly among the most critical in the world.

While the consensus in the United States and the rest of the world blindly accepted the euphoric postulates about a new paradigm U.S. economy displaying unprecedented wonders of productivity and profit growth, we insisted all along that the statistics showing such miracles were grossly misleading.

In particular, we have kept emphasizing that — from a macroeconomic perspective — the U.S. economy was badly mismanaged at the expense of savings, capital formation and profitability. Rather than a miracle, we discerned the wildest, most vulnerable "bubble economy" in history. What's more, we identified credit excesses of unprecedented, outrageous scale that have overwhelmingly financed two bad things: private consumption and financial speculation.

For us, in fact, the developing bust of the U.S. bubble economy has only two comparable precedents in history. One is the American bubble-and-bust experience of the 1920–30s, and the other is Japan's equivalent experience since the late 1980s.

Yet, despite many similarities, there is one difference of supreme importance between America's present imbroglio and those two earlier episodes. In the 1920s, America was the world's leading creditor country running a chronic surplus in its current account, and the very same has been and remains true for today's Japan. The inherent implication for such countries is a fundamentally strong currency, warranting full autonomy for monetary policy.

This time, however, the U.S. economy is slumping against the backdrop of the most adverse external conditions. Today's United States is the world's greatest debtor country. It runs a preposterous, chronic current-account deficit from which an ever more preposterous foreign indebtedness accrues. Intrinsically, the monetary policy of such a country is hostage to the willingness of foreign investors and lenders to finance its spending excesses. ***They may force it to raise interest rates even when the economy is in depression.***

Earlier we noted that the chronic U.S. annual trade gap and chronic current U.S. capital outflows add up to around \$900–1,000 billion, needing accommodation through capital inflows. For us, it is a compelling conclusion that future capital flows into the United States are bound to fall considerably short of these outrageous sums. Never before has a deficit country also sent such massive amounts of capital abroad for foreign investment. It is an unprecedented experience in economic history. Manifestly, this is testament for extremely loose money.

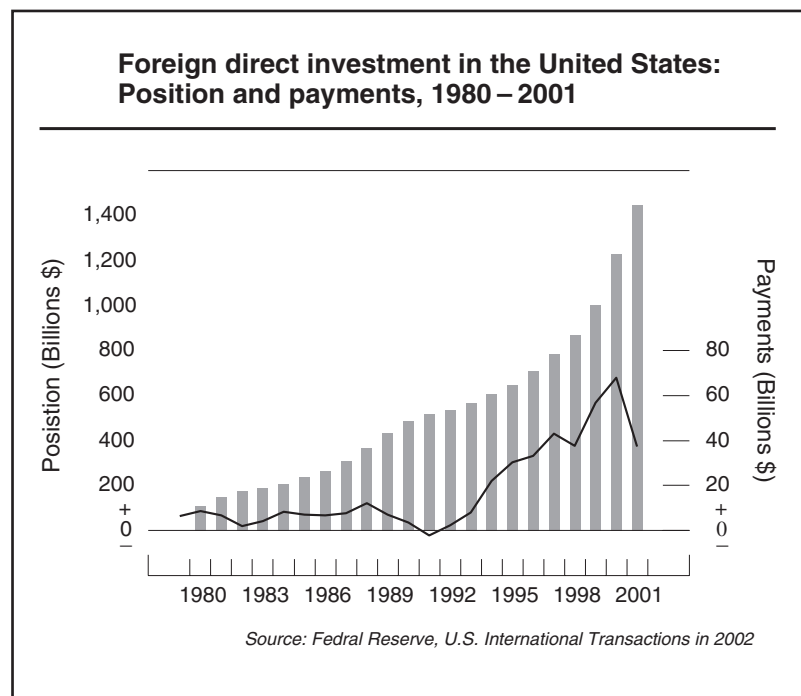
***Considering all circumstances, we think that an outright dollar disaster, far worse than the crash in 1985-87, is inevitable.***

First of all, the U.S. trade gap and the U.S. capital outflows needing accommodation through capital inflows have been allowed to grow to an absurd, unmanageable size. More importantly, the motivation of these capital inflows is collapsing into the worldwide recognition that the admired new paradigm U.S. economy was a mirage at best, and a systematic fraud at worst.

## **DUPED FOREIGNERS**

There is now a general inclination to blame all troubles on the pervasive corporate accounting scandals that have shaken the confidence of investors at home and abroad. But this confuses cause and effect. The true, commanding problem of the U.S. economy and the stock market is not the accounting fraud but an effectively miserable profit performance that has aroused the fraud.

As we have documented many times, this unusually miserable profit performance has been true for the whole economy since 1997. Ironically, the direct investments of foreign firms have fared considerably worse. For them, it has been a profit disaster. This probably reflects the disproportionate share of foreign firms' investments in manufacturing and finance, where the profit performance has been particularly poor.



Foreign direct investments at end-2001 totaled more than \$3 trillion at market values and about half of that amount at current cost. But looking at their miserable return, it was gigantic malinvestment. In 1997, earnings from direct foreign investments amounted to \$43 billion. These peaked in 2000 at \$69 billion, collapsing in 2001 to \$37 billion. The rate of return was a little over 2%, measured on the costs of these investments.

Considering the miserable corporate profits, the weak dollar, the uncertainties about the U.S. economic recovery and the accounting scandals, it is implausible that foreigners will add more dollar-denominated assets to their portfolios. Nobody can be so stupid. Yet the record suggests that indeed many can: that at almost every point some people will be prepared to bet that the stock market or the dollar has bottomed out.

Still, we think this brand of stupidity has likely run its course. The idea that foreigners will continue to invest and lend into the U.S. economy at the ludicrous levels of the past is absurd. There is sure to be a sharp slowdown in capital inflows, and that in itself fully suffices to hammer not only the dollar, but also stocks and bonds. Even if the U.S. economy manages to stay out of recession for a while, the dollar-related crunch in the financial markets will make recession inevitable.

## **WHAT HAPPENS WHEN THE NON-NATIVES GET RESTLESS**

The biggest threat — one that would spell outright disaster — looms of course in the possibility that the owners of the trillions of existing foreign dollar holdings will become restless. To depress the dollar and the financial markets, it is not even necessary that they attempt to get out altogether. For these effects to happen, as explained, a broad move into hedging would be enough.

In such circumstances, the Federal Reserve will face a Catch-22. While the developing financial crunch and the weakening economy will require drastic monetary easing, the plunging dollar will require higher interest rates. As the realization spreads that the Fed is effectively helpless, strong, negative psychological reactions will come into play, adding to the pressure on the dollar and the markets.

***The policy dilemma confronting the Federal Reserve and the government can be simply stated: Outrageous borrowing and spending excesses have made the economy and its financial markets dependent***

*on uninterrupted capital inflows of preposterous scale. Principally, the U.S. external position is in our view completely out of control, both in the current and capital accounts.*

American policymakers and Wall Street have long hailed the soaring U.S. trade deficit as the outgrowth and emblem of outstanding U.S. economic and financial strength. When the International Monetary Fund recently called America's current-account deficit one of the greatest risks to the world economy, Paul O'Neill, America's Treasury secretary, answered in public that the Fund's economists do not know what they are talking about. In his words, such a deficit is a "meaningless concept" to which policymakers should pay no attention.

In detail, he argued that this deficit merely reflects the fact that foreigners, attracted by superior corporate returns, simply want to invest in America. The current-account deficit, according to O'Neill, is no more than the accounting counterpart of those capital inflows. Since these flows reflect rational investment decisions of private firms and individuals, there is no reason the government should know any better than they do.

These people possess an incredible ability to put the most negative economic and financial features of the U.S. economy into economic and financial glory. Such flat dismissal of a huge trade deficit as a non-problem happens to have a famous precedent in history. Its messenger at the time, in 1985–86, was Nigel Lawson, Britain's Chancellor of the Exchequer. In due time, he was presiding over a steep fall of the pound. George Soros gained fame with a billion-dollar profit in betting against the Chancellor.

### **THE DAY OF RECKONING**

How fast and how far can the dollar fall this time? That's the question.

The day of reckoning for the strong currency of a deficit country inexorably arrives when the glory of the boom finally gives way to the bad news of recession. So the answer depends crucially on the U.S. economy's impending performance. An economy sliding back into recession would definitely spell disaster for the dollar.

In the 1980s, the dollar shed around 50% of its value against the other major currencies within two years. For most people, a repeat of such a crash is unthinkable. For us, the decisive consideration is that the U.S. economy's internal and external imbalances today are far worse than they were in the 1980s.

In 1987 foreign central banks had to prevent the dollar from falling into a black hole by financing the whole of the year's external deficit, amounting to \$163.5 billion. But within three years it shrank drastically, to \$90 billion. And though the dollar collapsed, the economy still managed a soft landing. At the same time, despite the brief crash in October 1987, stock indexes gained more than 50% during the second half of the 1980s. Long-term interest rates fell — from an exceedingly high level — and annual U.S. real GDP growth averaged 3%.

The smoothness with which the U.S. economy and the financial system adjusted at the time to the dollar's crash had reasons that, with the benefit of hindsight, are easy to see. First of all, the external imbalances were on a far more moderate scale than they are today. But there was another reason too — one that represents a most important difference to present conditions.

In the '80s, U.S. capital inflows occurred primarily through banking transactions between the Euromarket and the U.S. money market, and through trade credit. There was virtually no measurable involvement of foreign investors in the U.S. securities market.

This time, in diametric contrast, the dollar got its prolonged, stellar strength overwhelmingly through capital inflows into the securities markets, implying a close link between the former bull market in U.S. stocks and the dollar. We wonder whether the sudden, dramatic deterioration in the U.S. stock market is not importantly due to this fact. It begins to look like a free fall for both stocks and the dollar.

With a current current-account deficit of more than \$400 billion at annual rate and additional large U.S. capital outflows, it should be clear that there is unprecedented downward pressure on the dollar. In fact, we wonder what can possibly stop its plunge under the existing atrociously unbalanced U.S. economic and

financial conditions. What will keep the dollar afloat once the prevailing illusions about the U.S. economy's health and strength wane?

### **THE FOREIGN PILLAR**

The one thing that still separates the dollar from its day of reckoning is widespread hope for the U.S. economy's imminent recovery and a return to the high growth rates of past years. In its just published *Monetary Policy Report*, the Federal Reserve predicts real GDP growth rates of 3–4% for this and next year, sticking to the view that this will be the U.S. economy's mildest and briefest recession.

We regard this as a ludicrously optimistic assumption. Principally, a recession reflects the economy's readjustment from the excesses and distortions in its demand and output structures that accumulated during the boom. Pure and simple, the recession's depth and breadth, therefore, crucially depends on the scale of those prior maladjustments and their effective correction.

The first thing to see about the present U.S. economy is that the scale of the credit excesses of recent years defy description and measurement. Pointing to the low inflation rate, Mr. Greenspan dismissed any need for restraint. The insidious outgrowth of this reckless laissez-faire monetary policy was a monstrous mess of multiple bubbles and massive structural distortions. These occurred both in the economy and its financial markets, and implicitly inhibit future economic growth.

### **GREENSPAN FANTASIES**

Obviously trying to instill confidence and optimism, Mr. Greenspan, and many others, of course, keeps making upbeat statements. Some of the arguments are of a kind that defy any economic logic and therefore cause us to question either his sincerity or his reasonable knowledge in economics. Right at the outset of his recent testimony to Congress, he made two such statements.

Mr. Greenspan began by saying, *"the mildness and brevity of the downturn are a testament to the notable improvement in the resilience and the flexibility of the economy."*

He then added that the *"fundamentals are in place for a return to sustained healthy growth: Imbalances in inventories and capital goods appear largely to have been worked off; inflation is quite low and is expected to remain so; and productivity growth has been remarkably strong, implying considerable underlying support to household and business spending as well as potential relief from cost and price pressures."*

It should meanwhile be generally recognized that the U.S. economy's boom of the last few years was not at all propelled by profit-driven record capital investment but by the wildest consumer borrowing and spending bubble of all time. Of the many distortions that the Fed's prolonged, extreme monetary looseness created, this one is the worst and biggest in the economy. It showed strikingly in the collapse of the personal savings rate from 5% of disposable income in 1998 to virtually zero in 2001. Its counterpart was consumption's increase to a record-high share of GDP.

A recession reflects the process by which an economy readjusts to its normal, sustainable pattern of saving, consumption and investment. *In this light, it should be evident that in the current U.S. recession, more than anything else consumer spending ought to have adjusted downward from its excessive levels of the boom.*

*But what has happened is the exact opposite — consumer spending has continued to boom at the expense of saving. And Mr. Greenspan hails this as a testament to the economy's flexibility, calling it "an important stabilizing force for the overall economy."*

In the short run, this is certainly true. But ludicrously, this consumer borrowing and spending binge in the past few years has been America's single biggest bubble to start with. And just as ludicrously, this outright bubble pattern is suddenly represented as a great positive for economic growth.

As consumers finally begin to realize that a continuous plunge of the stock market is burning what they considered their reserves for retirement, they will return to saving from their current income willy-nilly. It will

be the final fatal blow for the recovery and economic growth. Normally and in the longer run, it is rising employment and rising wealth that fuels rising consumer spending. Today, both are negative.

While private payroll employment has moderately declined through June, financial wealth is in a steep and accelerating fall. According to the Fed's flow of funds account, by the end of the first quarter it had already given back close to two-thirds of its big run-up in the second half of the 1990s.

Against these strongly negative influences, consumer spending has held up surprisingly well because the mortgage market offered massive cash-out refinancing opportunities. Low-rate home equity loans have, for the time being, largely offset these depressing influences on consumer spending. But this is definitely not going to last.

Progressive losses in the stock market, further slashing the consumer's wealth, will exert growing pressure on him to serve again from current income — at the expense of his spending. This will finally pull the rug out from under the economy. For us it is the inevitable, true end of the U.S. bubble economy.

### **THE CONSENSUS CLINGS TO HOPE**

What ails the U.S. stock market? What, exactly, is it that makes us so sure of an ongoing long decline for which there is no end in sight? It has quickly become the favorite explanation that the accounting scandals have shaken the general confidence in the economy and in particular the faith of investors. It's a most superficial explanation, in our view.

From the numerous reports that we read, we conclude that the general sentiment and assessment of the U.S. economy is anything but outright pessimistic. Former high-riding hopes of a robust recovery have been revised downward. But apart from a few lonely outsiders, like ourselves, nobody seems to consider the possibility of a "double-dip," let alone of protracted economic weakness and a prolonged, savage bear market in equities.

Considering the actual deluge of bad news about the economy, the general sentiment about the economy and the markets, as expressed in most reports, appear to us pretty optimistic. Above all, the sky-high stock valuations and the low saving rate are strikingly typical of a general lack of serious anxiety.

Imagine, S&P 500 stocks are now trading at a record 60 times earnings, as against 28 times a year ago, while earnings per share have fallen from \$45 to \$25. Plainly, the downturn of market sentiment is vastly lagging the downturn of the relevant economic facts. An investment community that holds stocks at these horrendous valuation levels can't possibly be pessimistic about the economy. In fact, consensus profits forecasts remain wildly optimistic.

### **A MARKET WITHOUT BUYERS**

No, it's not optimism that is lacking on Wall Street. Thinking it over, we have come to the conclusion that what ails the U.S. stock market above all is a lack of potential buyers possessing the pecuniary means to buy stocks.

The biggest primary buyers in the past few years, as everybody knows, were the corporations themselves through mostly credit-financed mergers, acquisitions and stock buybacks. Even bigger buying came in 2000–2001 through foreign direct and portfolio investment.

In the first quarter of 2002, for the first time in a decade, U.S. corporations sold more stocks than they bought. As to foreign investors, they have until quite recently still been putting new money into U.S. stocks, but at a dramatically slower pace.

The two groups were manifestly decisive for the market's past bull run, and just the same, their large-scale disappearance as buyers is now crucially making for the market's weakness. New buying now essentially depends on that part of the investment community that is the traditional and normal key buyer of stocks, and these are mainly private households and institutional savings institutions, such as pensions funds and life insurance.

In short, a rising stock market needs a flow of new saving from current income. But that's what America lacks most of all, considering zero personal saving, zero business saving and zero institutional saving. What's more, all of these potential stock buyers are already grossly overweighted in stocks.

In the same vein, balance sheets overall have become far too strained to allow for new stock purchases. In the absence of new saving, they keep deteriorating. Not only that, as the market keeps sliding, a rapidly increasing amount of money lies in wait to pull out of stocks whenever a rally offers better prices. Any rally is thus quickly nipped in the bud.

## **ILLUSIONS ABOUT MONEY PRINTING**

But what is the Fed doing against this rampant wealth destruction? What can it do?

Frankly speaking, the Fed can do close to nothing, given a federal funds rate already at a rock-bottom level. Another rate cut from this level might shock the market as a sign of desperation. We assume that together with the leading investment banks, the Fed has repeatedly intervened in the stock market with high leverage through the futures markets. But in comparison to a market capitalization of ten or more trillion dollars, its potential intervention power looks more like a drop in a bucket.

Meanwhile, most American economists sleep well in the comforting belief that central banks are all-powerful in steering economies and markets. If push comes to shove, they simply resort to printing money. In this vein, it has been a popular argument that the past bull market primarily resulted from the rampant money growth during these years engineered by the Fed. This is another shockingly naïve and simplistic assumption.

The Fed's influence on the economy and the markets begins and ends with the use of two levers: its federal funds rate and the reserve money that it makes available to banks. It is then up to the banking system to turn the two levers into rising loans and investments in the securities markets, and thereby into accelerating money growth.

*Yet, many times in history, the monetary ease of central banks has been thwarted by the refusal or failure of the banking system to do its job of money and credit creation.*

In reality, the rampant money growth of the past several years was far more an effect of the booming stock market than its cause. It actually reflected heavy borrowing by corporations, hedge funds and others *for the purpose of purchasing stocks and bonds*. In this way, the Fed's aggressive monetary ease clearly facilitated and fostered the boom. But just by itself, its moves would have had zero economic or financial effects.

The final indispensable, crucial requirement for the boom was a herd of investors actively borrowing on a massive scale for stock purchases. For obvious reasons, America has run out of these borrowing and money-creating investors.

## **IMPOVERISHING AMERICA**

While general attention focuses on the accounting and corporate governance scandals and their adverse effects on market psychology, there is amazingly little realization of the dramatic deterioration that, as described, has taken place in the underlying economic and market conditions.

From what we read and hear, we can only conclude that investors have by no means given up on the stock markets in the United States and around the world despite the huge losses they have already suffered. The main straws at which everybody clutches is a prevailing belief that the U.S. economy's rebound is assured and that the U.S. economy is fundamentally in good shape.

We vehemently disagree on both accounts: *first*, the recovery hopes are illusory; *second*, the U.S. economy is in its worst shape in history, far worse than that of Japan, and far worse than it was at the beginning of the depression in the 1930s. The U.S. economy's overall structure has been damaged as never before.

When Americans talk of economic fundamentals, they have mainly the inflation rate and productivity growth in mind. As to the low inflation rate, it should be obvious that, by itself, it exerts no effects at all. The underlying inherent assumption seems to be that it permits monetary stimulation.

As to productivity growth, many American economists like to call it *the most important variable in the economy*, being supposedly the main source of higher living standards and profits. Apparently, it worries few of them that the recorded jump in productivity growth during the past few years badly failed to do any such wonders to profits even though the economy was booming.

As we have repeatedly explained and emphasized, most of the jump in U.S. productivity growth came from the soaring output of computer makers, being sold with rapidly rising power. Translating this through hedonic pricing into falling prices, the government statisticians turned soaring computer power into additions to real GDP and from there into higher productivity growth. Ironically, the high-tech sector, with its recorded productivity miracle, is among the worst profit performers in the economy.

For this and other reasons, we have always discarded the American veneration of productivity growth as grossly misplaced. First of all, there are tremendous measuring problems; and second, its income effects are unpredictable.

The growth of true prosperity has in reality but one source: saving and capital investment in tangible assets. The U.S. economy has always been relatively weak on both accounts, but under the latest greed and consumption culture, the two aggregates have been devastated as never before. By the measures of growth in foreign indebtedness, domestic net saving and net capital investment, the past few years have been a period of dramatic impoverishment for America.

While American propaganda was trumpeting economic miracles, due to superior high-tech investment and superior corporate governance, the official data for years have been portraying an economy whose capital formation and profitability was badly going down the drain.

### **LOCKED-UP FOREIGNERS**

Back to the implications of the U.S. economic and financial imbalances for the dollar and for the U.S. financial markets. Reading many reports and forecasts, we note a striking complacency about the dollar's stability even from economists who have been rather critical of the economic development. In general, the possibility of a steep slide is strictly discarded.

There are plenty of explanations why its potential fall is supposed to be quite limited — that the case for buying other currencies on their own merit is weak, too; that in an uncertain global economic and political climate the dollar is the one safe haven currency; that U.S. productivity growth remains much faster than in the rest of the world; that financial markets outside the United States are far too small to absorb the trillions of foreign-owned dollar assets; and so on.

All these and other arguments reveal an amazing ignorance of how markets work and how overall valuations come about — that is, through small trades at the margin, and the resulting prices apply to the whole of the existing assets or liabilities.

We assume there is a lot of inertia in the forward markets. But all it needs to send the dollar into a black hole are two minor things: *first*, that new capital inflows fall short of the huge sum of the U.S. trade deficit and current U.S. capital outflows; and *second*, that a fraction of the owners of the \$9 trillion existing foreign holdings of dollar assets decides to hedge against the falling dollar by selling it in the forwards market, let alone a possible decision to pull out.

As to the argument that financial markets outside the United States are far too small to absorb those trillions of dollars held by foreigners in the United States, it has to be realized that all this money is definitely locked up

in the United States. The foreign investors can sell their assets, but in the aggregate, they are unable to exit the dollar. This money could enter the U.S. financial markets because the United States, through its trade deficit and capital inflows, made a stream of domestic dollars available to foreign investors. Buying these dollar outflows, foreign investors poured them back into the U.S. financial markets.

But who is going to make the euros and yen available for the foreign investors who want to switch out of the dollar and back into the currencies of surplus countries? Nobody.

## **CONCLUSIONS:**

Fraud and poor profits in the United States are not bad apples among a heap of good apples. Both are systemic. The whole new paradigm economy was illusion and fraud.

Phony explanations of Wall Street's alarming dive abound. The conventional still-complacent view holds that the stock market's disastrous decline is not caused by the economy but by an irrational deterioration in market psychology.

According to government and Wall Street mantra, the U.S. economy has a *sound structure* and *sound fundamentals*. As we have kept emphasizing, the indispensable key conditions for growing prosperity are savings, net capital investment and profitability. The gross macro- and microeconomic mismanagement and the associated rampant credit excesses of the past several years have devastated these crucial growth fundamentals in the United States as never before.

The U.S. economy's structure is frighteningly frail and vulnerable, and that is what the stock market begins to reflect. The great credit and bond market crisis is waiting in the wings.

Within the next few months, it will become the general recognition that the U.S. economy is on the verge of sliding into a prolonged, severe recession. This spells unprecedented havoc to U.S. stocks, bonds and the dollar. Under these circumstances, there is but one highly lucrative investment for dollar-based investors: German and French government bonds.

## **THE RICHEBÄCHER LETTER**

Dr. Kurt Richebächer, Editor  
Published by The Fleet Street Group  
Laura Davis, Group Publisher

Doug Noland, Market Analyst  
Jeanne Smith, Marketing Manager  
Mark O'Dell, Design & Layout

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling 1-800-433-1528, or from outside the U.S. by calling (508) 368-7498. Fax (410) 454-0403. Subscription rates: in the U.S.: \$497. Outside U.S.: \$545. Published monthly. © *The Richebächer Letter*, published by The Fleet Street Group. All rights reserved. Reproduction in part permitted if source and address are stated. *The Richebächer Letter* presents information and research believed to be reliable, but its accuracy cannot be guaranteed. The Latin maxim *caveat emptor* applies-let the buyer beware. The publisher of the *The Richebächer Letter* does not itself endorse the views of any of these individuals or organizations, or act as an investment advisor, or advocate the purchase or sale of any security or investment. The Company, its officers, directors, employees and assorted individuals may own or have positions in recommended securities discussed in this newsletter and may add or dispose of the same. Investments recommended in this newsletter should be made only after reviewing the prospectus or financial statements of the company.